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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET During April-July, 1963, Industrials fluctuated within an extremely narrow range (less than 5%). From May to July, Rails also confined their movements to a narrow (less than 5%) range. Such an area is known as a "line". On July 17, Industrials broke below their lower line limit of 701.35. On July 22 the Rails confirmed the bearish indications of Industrials -- by breaking below their own lower line limit of 168.97.

The formation of a true line is a rather rare occurence these days, although lines were a common formation a generation ago. Robert Rhea was of the opinion that the breaking of a line signified a change in the secondary trend (and at times a change in the primary trend). My own studies of line formations confirm Rhea's observations.

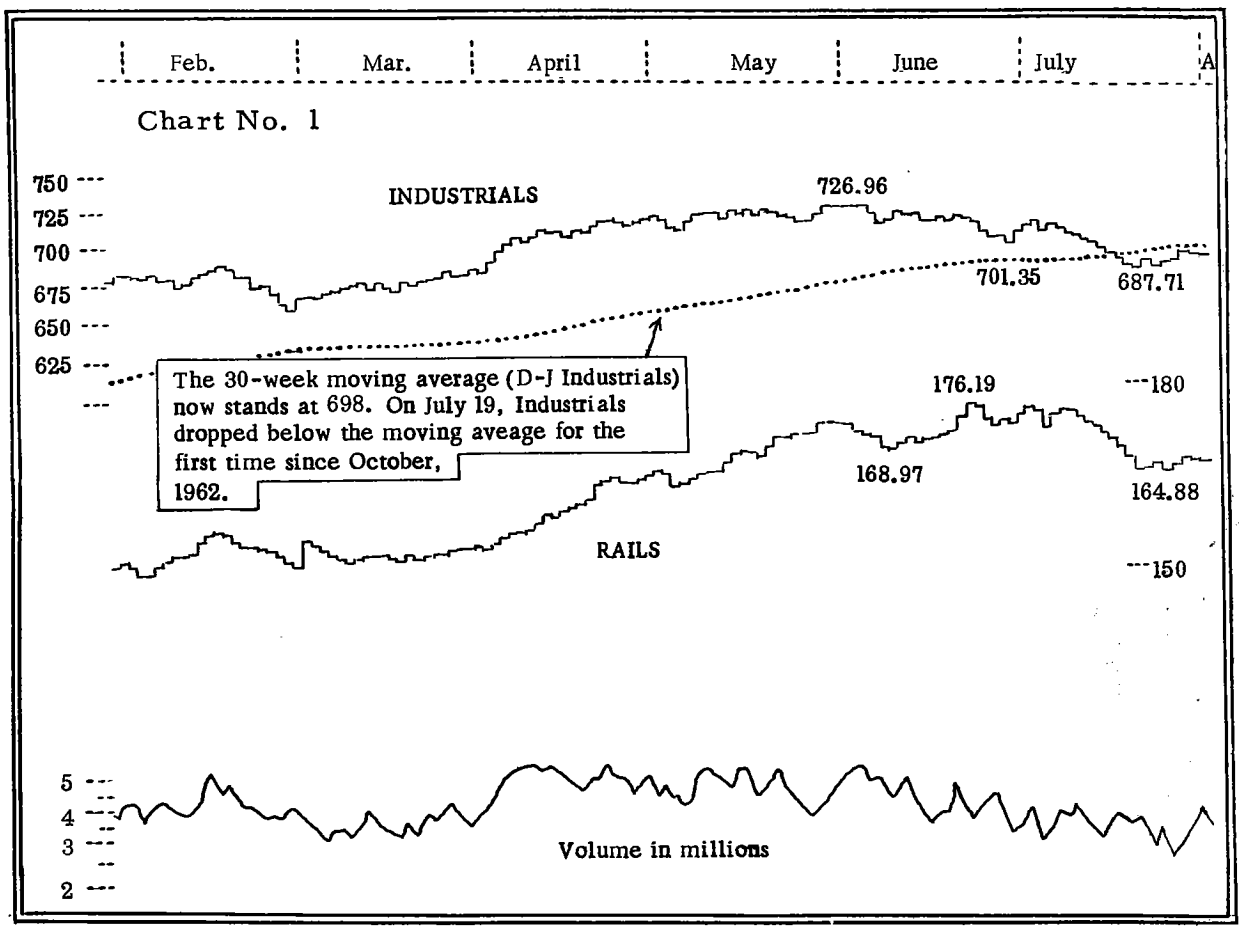
Volume during and after the July 22 line penetration was light. The implication being that despite the breaking of the long line, selling pressure (at least so far) has not been forthcoming.

The violation of the line came as part of a string of 10 consecutive days of decline (see chart #1). For this reason (and despite the line penetration) the last Letter warned: "The situation has now become heavily weighted on the downside, and the normal expectation would be for a corrective rally to start at any time."

On July 25 the rally began. A one-third correction of the June-July losses would take the Industrial Average to 700; a two-thirds correction would take Industrials to 713. In other words, 700 to 713 would be the normal expectation for a corrective movement against what appears to be the prevailing secondary downtrend.

SECONDARY REACTION? From the 1962 lows of 535.76 (Industrials) and 114.86 (Rails), the two Averages rose 199 points and 62 points respectively to their 1963 recovery peaks. The recent (June-July) decline retraced 23% of the 1962-63 Industrial gains, 20% of the 1962-63 Rail gains.

Under Dow Theory, a movement is said to terminate at the point where the Averages register their last joint highs or lows. Since the two Averages recorded their last joint highs on May 31, 1963, we can say that the decline (so far) has consumed two months. Therefore, in duration the June-July decline qualifies as a secondary reaction



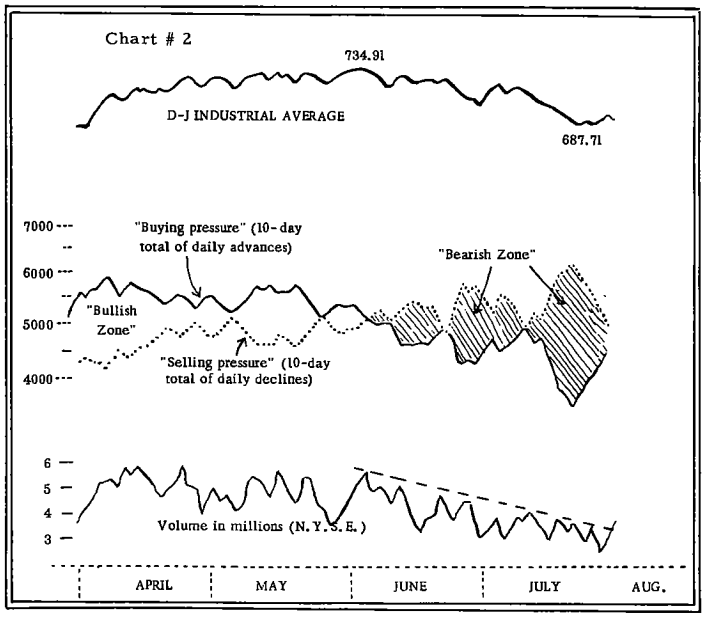
(secondaries tend to last three weeks to three months). In extent, however, the June-July drop was sub-normal (secondaries tend to retrace 1/3 to 2/3 of the preceding major advance). Nevertheless, because of the time element and because the Industrial decline assumed the form of two distinct downward legs (secondaries almost never end with a single movement), I feel that the June-July retreat should qualify as part or all of a secondary correction of the 1962-63 rise.

SHORT TERM: The recent secondary lows came at 687.71 (Industrials) and 164.88 (Rails). Joint penetration of those points on increasing volume would obviously signify a continuation of the secondary downtrend. However, if one or both Averages persistently refuse to drop below those levels, the stage will be set for a further recovery towards the May 31 highs.

TECHNICAL NOTES: On August 1 the 10-day average of odd-lot ratios indicated that odd-lot selling has dropped to the lowest rate of selling since January. This swing toward less selling is a definite minus in the technical picture.

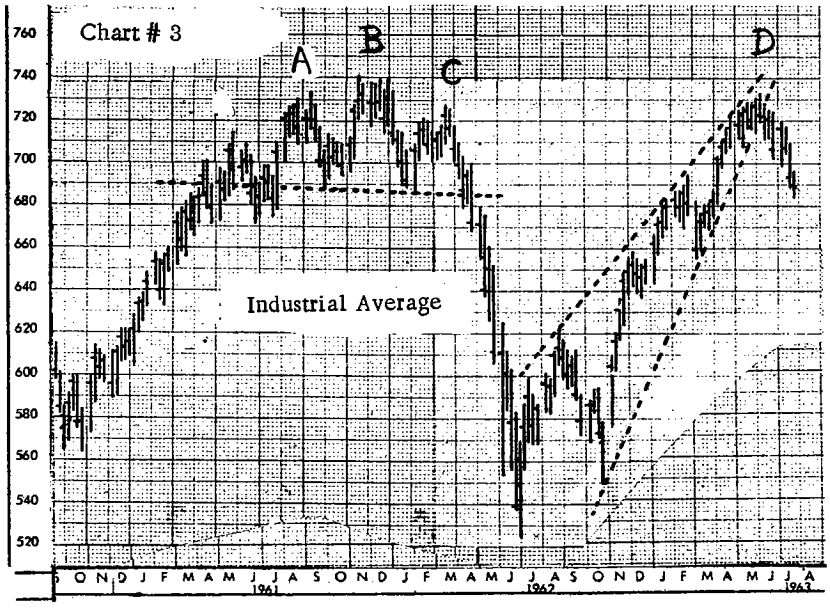
Tri-Continental warrants (a market bellwether) showed up poorly on the recent rally. If the warrants touch 34 on the next decline they will have reconfirmed their bearish downtrend.

BUYING AND SELLING PRESSURE As of this date (August 2) selling pressure has held above buying pressure for forty consecutive days (see chart #2). On July 23 the selling line rose to 6350 (i.e., a total of 6350 declines over the past 10 days). This suggested a fairly high degree of selling pressure -- and at least a partially "oversold" market condition. Following July 23, the market rallied and the two lines headed together again.



The question is asked: "How oversold is oversold?" An extreme example: in June, 1962, the selling line rose to 8000 while buying dropped to 3000. This was one of the greatest oversolds in the history of this study. In general, however, when selling rises above 7000 and buying drops below 3500 the market is considered to be under severe selling pressure, and a corrective rally can be expected at any time.

The last few Letters have emphasized the steadily diminishing volume during the period when the selling line was dominant. This situation continues. Nevertheless, subscribers should remember that as long as the selling line is above buying, the study is saying "caution". When the selling line is rising and the buying line is dropping and volume is increasing the study is saying "danger". This latter situation has not yet occurred.

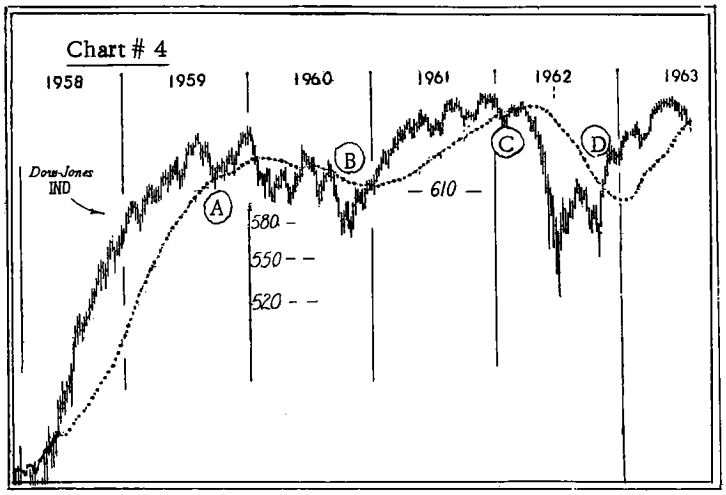


THE 720-734 BARRIER In September, 1961, the Industrial Average rose to the 726 level for the first time in history (see point A, chart #3). A decline ensued, followed by a new rally which by December 14, 1961 (B on chart) took the Industrial Average to an all-time high of 734.91. Another decline began almost immediately, and this was followed by a third rise (C on chart) into the 720-734 area. This third advance completed what appeared to be a perfect "head-and-shoulders top". The resultant collapse (March-June, 1962) made stock market history.

From the June, 1962 low of 535.76, the Industrial Average turned up and embarked upon an amazing rise which, by May, 1963 had succeeded in taking Industrials into the 720-734 area for the fourth time in two years. As seen on the chart, the 1962-63 advance assumed the form of an extraordinary "rising wedge" pattern. A rising wedge (discussed in many previous Letters) suggests a formation in which upward momentum is slowly diminishing.

On May 31, 1963, the Industrial Average reached a post-crash recovery peak of 726.96, and this point (D on chart) also corresponded with the apex of the rising wedge. Interestingly enough, point D occurred within 1/2% (3 points) of the preceding peak at point C (point C, of course, being the "right shoulder" of the 1961-62 head-and- shoulder top).

During the recent June-July, 1963 period, the senior Average retreated steadily, to the accompaniment of decreasing volume. As this Letter is written, we find the Industrial Average near the "700 level" and about 20 points below the formidable 720-734 area. The question now is -- even if the market is basically in trouble, what are the odds that we will see (as per 1961-62) at least one more attempt by Industrials to hurdle their preceding recovery high? Answer: obviously, no fixed rule can be applied here. However, based on diminishing volume indications during the decline and based on past history, the chances are fairly good that the Industrial Average (but not necessarily the majority of issues) will make some sort of attempt to enter the 720-734 area again.



THE MOVING AVERAGE Because of the recent penetration by Industrials (see chart #1) of their own moving average (M. A.), I have received a number of requests for a fuller explanation of that event.

The long-term or 30-week moving average represents the average price which investors have been willing to pay for a group of "blue-chip" stocks over a period of 30 weeks or approximately seven months. Seven months is a reasonably long period of time, and the use of this time period in the construction of the M. A. tends to eliminate minor fluctuations which have no real meaning as far as the secondary or primary trend is concerned.

In general, as long as the M. A. is rising we can say that experienced investors (i. e., the type of investors who tend to deal in Dow Jones stocks) are willing to pay more and more for high-grade equities. In other words, while the M. A. is advancing it is safe to infer that (in the opinion of experienced investors) the Dow stocks are continuing to appreciate in value. Conversely, as long as the M. A. is declining, we can infer that experienced investors are willing to pay less and less for high-grade equities (i. e., experienced investors believe that the Dow stocks are continuing to depreciate in value).

The major (and active) part of a bull movement is usually signalled by an upward penetration of the Industrial Average through the M. A. From that point on, as long as the bull trend remains intact, the Industrial Average will tend to hold above its 30-week M. A. The converse is true during an important bear movement.

The writer possesses a chart of the Industrial Average and its M. A. going back to the 1940's. It is a fact, however, that the character of the market tends to change somewhat during various periods of history. For this reason, I believe the most significant study might entail a recent history of the relationship of the Industrial Average and the M. A., a history of say the past six years.

The last half-dozen years have been characterized by long, persistent swings in the Industrial Average. Moreover, a study of chart #4 will show that these movements were usually clearly signalled by penetrations of the Industrials through their M. A. For instance, Industrials penetrated their M. A. in May, 1958, thereby touching off one of the broadest and most amazing advances on record. Industrials held above the M. A. for sixteen months until September, 1959 (point A on chart). This penetration proved to be the signal for trouble -- but a premature one. A second rally carried Industrials slightly above the 1959 high in January, 1960. A long decline followed, a decline which did not terminate until October, 1960.

In December, 1960, Industrials again bettered their M. A. (B on chart), and this time Industrials held above the M. A. for thirteen consecutive months -- until January, 1962 (C on chart). That penetration was followed by the violent crash of 1962. Industrials hit their low in June of 1962.

In October, 1962, Industrials again rose above the M. A. (D on chart). The ensuing rise took Industrials to the recent May 31 recovery high of 726.96. On July 19 (having held above the M. A. for nine months) Industrials again broke below the M. A. (E on chart).

What does the history of the Industrial Average and its M. A. suggest in regard to the current situation? For one thing, each downside penetration by Industrials through the 30-week M. A. came after the advance-decline ratio had already topped out. Industrials broke below their M. A. on July 19, only two weeks ago. This would suggest that the peak of market strength has passed, and that the A-D ratio topped out two months ago -- on May 31, 1963.

Secondly, it should be remembered that the 1959 downside penetration (A on chart) was followed by a slight new high on Industrials before the major decline. The 1962 downside penetration (C on chart) was followed by a two-month rally attempt which failed to establish a new high. The current (July 19, 1963) penetration has been followed by a rally. It is still too early to tell whether we will now witness another attempt by Industrials to touch the highs (as in 1959) or whether Industrials will push half-heartedly upward as in the first quarter of 1962. The danger signal has been registered, however, and it is saying (1) the odds are that the A-D ratio has topped out; (2) the Industrials may try again for the high -- if they do, such action should be used as a selling opportunity.

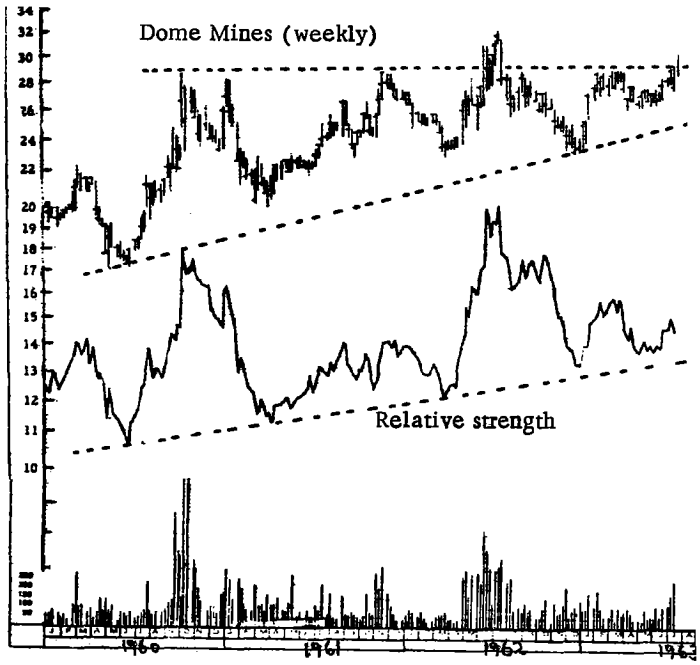
LATE NOTE: On August 1 the advance-decline ratio on the American Exchange broke to a new 1962-63 low. This action must be taken as bearish. It means that the declining tendency on the junior Exchange has now surpassed even the worst period of 1962.

STOCKS Our 444 stock tabulation shows that 257 issues (58%) are now holding above their 30-week moving average (a drop of 3% from last week -- and the lowest bullish percentage in many months).

Superior relative strength is still much in evidence in the Oil group (Standard of Jersey, Socony, Champlin Oil); Mining & Smelting (Cerro, Amer. Metal Climax, Howe Sound); Textiles (Burlington) and Autos (although this group is now beginning to weaken).

Weak groups (candidates for shorts) include Aircraft (Martin, North American, Lockheed, Boeing), Tobaccos (Reynolds) and interestingly enough Telephones (Amer. T. and Gen. T both show poor relative strength but are too sluggish to be short candidates).

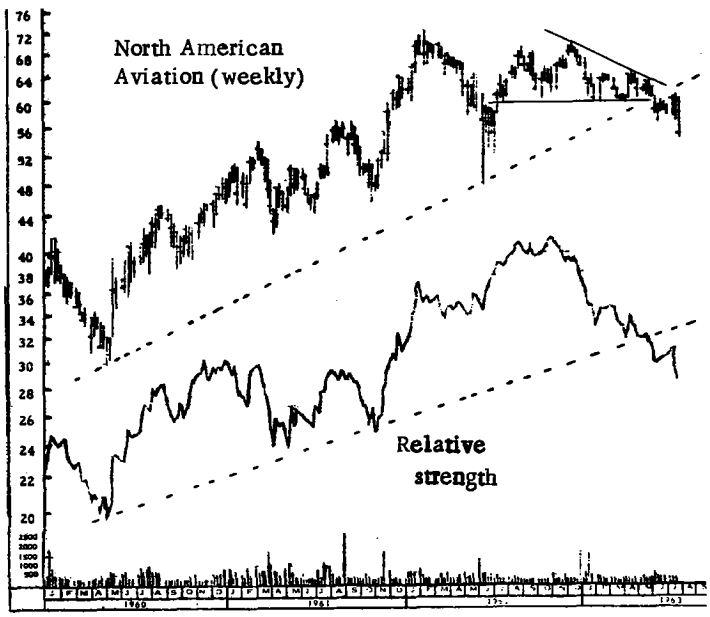
Relative strength trends can be remarkably persistent, sometimes lasting for many years. It should be remembered, however, that the longer the trend, the nearer the point of eventual reversal. I find it ironic (in the face of the predicted capital good build-up) to note that the following four groups have been (and still are) showing poor relative strength: Steel, Paper, Rubber and Machinery. These groups would literally comprise the backbone of any potential capital good boom.



Golds, which have been recommended repeatedly, act very well. The weekly chart below shows Dome in a simply huge ascending triangle. An attempt at a "breakout" occurred in 1962, but this was followed by a reconsolidation. The stock is now breaking out again as it betters 29 1/2. Everyone should have some in their portfolio (i.e., Homestake, Campbell Red Lake, Dome, or Giant Yellowknife).

The two small charts show the excellent action in two gold stocks, Giant Yellowknife and American South African. Both of them can be purchased for investment accounts now.

The Aircraft stocks continue weak as typified by the weekly chart of North American. NV has broken below an ascending triangle and also below a long-term trendline. Its relative strength line has also cracked. I list the stock as a short on any rally.



Large charts courtesy of Traders Research, P. O. Box 2466, St. Louis 16, Missouri.

Small charts from Quote Digest, 110 N. Lorraine, Wichita, Kansas.